

9.01 Receivables

Accounts Receivable

Trade accounts receivable (A/R) result from sales of goods or services in the ordinary course of business, covered in ASC 606, *Revenue from Contracts with Customers*. Receivables that are not related to normal operations, such as amounts due from officers, employees or stockholders, are reported separately from trade A/R (ASC 310).

Trade A/R are reported in an amount equal to the consideration recognized in the transaction that has not been collected as of the date the revenue is recognized. The amount is recorded net of **trade discounts**.

Trade discounts are the difference between the amount that the entity's customer would normally sell the product or service to its customers for and the amount for which the reporting entity is selling the goods/services. This gives the entity's customers the ability to earn a margin upon the sale to its customers. The discounts also may be subject to increases as a customer's volume increases.

There are several other provisions often included in sales contracts that also potentially reduce the amount of consideration. These are referred to as **variable consideration** in a sales contract. They are estimated according to the guidelines for revenues from contracts with customers and reduce revenues recognized upon sale. They include:

- Discounts for prompt payment (ie, sales discounts)
- Reductions for returned goods
- Reductions for defective or nonconforming goods

Discounts for prompt payment are often expressed in terms of a formula, such as 2/10, net 30. This indicates that the customer may take a 2% discount if payment is made within 10 days. If not, no discount is taken, and the amount is due in 30 days. Those customers who are able will generally take advantage of these discounts because they represent a very high effective interest rate.

- With terms of 2/10, net 30, the customer is receiving a 2% discount for paying 20 days earlier than the entire amount is due.
- With approximately 360 days in a year, there are 18 20-day periods.
- The result is an effective rate of roughly 36% per year.

Many times, customers are allowed to **return goods** that they are unable to sell within a reasonable period of time. The customer will return the goods and receive a reduction of the amount to be paid or a refund of amounts paid. In such cases, since the goods are being returned, the reduction of the consideration to be recognized as revenue is net of the value of the goods being returned.

When an entity sells **damaged or nonconforming goods**, the customer may retain the goods and obtain a discount due to the defects or nonconformity. This enables the customer to discount their sales price so that they may sell them, rather than bear the inconvenience of returning them.

While all these items reduce consideration recognized as revenue, **they do not reduce the receivable**. They are, instead, recognized as **contract liabilities**. This is true if the entity has already received payment, in which case the liability represents a refund to be paid. If the revenues have not yet been received, the liability represents a reduction of the amount to be received.

Since these amounts are estimated when consideration is measured, they are subject to change. As a result, the contract liability is evaluated at each reporting date and adjusted as necessary.

Credit losses, as previously discussed, are the portion of trade receivables the seller does not expect to collect due to the customers' inability to pay. They are estimated considering the seller's experience, industry standards, economic conditions, and other factors that may affect customers' ability to pay. They are reported by recognizing credit losses on the income statement and reducing trade receivables with an allowance for credit losses, a contra-asset account.

In performing the evaluation of credit losses, a variety of methods may be applied, such as the following:

- *Discounted cash flow method* – Losses are estimated by determining the present value of the expected future cash flows.
- *Loss-rate method* – Losses are estimated as a percentage of total exposure.
- *Aging method* – The instruments are stratified, often on the basis of when they will mature, and different percentages are applied to each stratum.
- *Roll-rate method* – Losses are estimated on the basis of the time required for the conversion cycle, the period required for instruments to be realized.
- *Probability-of-default method* – Losses are estimated by multiplying a likelihood that an instrument will be defaulted upon by the balance of the instrument.

Most likely to be tested with respect to A/R on the CPA exam

After the initial acquisition and recognition of a financial asset, a current estimate of expected losses is measured each reporting period, using the same measurement technique as was used originally. The allowance is adjusted to the appropriate amount and the related increase or decrease in the allowance is recognized as an additional credit loss expense or a reversal.

In some cases, the amount that is unlikely to be collectible cannot be estimated. This could be for a variety of reasons, such as economic conditions or industry circumstances that are atypical. Under the guidelines in ASC 606, the inability to estimate collectability indicates that a contract does not exist. An alternative accounting method specified by the standard involves recognizing amounts received as a liability until such time that the credit loss amount can be estimated, or certain other conditions are met.

The inability to estimate credit losses precludes recognition of the receivable. When there is significant uncertainty as to collection, other methods of accounting may be used. These may include the cash basis, the cost recovery basis, or some other method. Under the **cost recovery method**, all payments received, including those designated as interest, are considered recoveries of cost and are not recognized as revenue or profit. When the cost has been recovered in its entirety, further payments will be recognized in income.

If, for example, an entity has sales of \$2,000,000, they expect half of their customers to take advantage of the 2% discount for early payment, and based on their past experience and industry knowledge specific to the industry, they expect uncollectible amounts will be 2 ½% of credit sales, they would record the events as follows:

A/R	2,000,000	
Credit loss expense	50,000	
Allowance for credit losses		50,000
Contract liability		20,000
Revenue		1,980,000

The balance in A/R is also reduced by collections on account and amounts written off.

Notes (Loans) Receivable

When an entity makes a loan to another entity or individual, it recognizes a note receivable, representing a **current** asset for portions expected to be collected **within one year** or one accounting cycle, whichever is longer, and a **noncurrent** receivable for the **remainder**.

If the **loan consists exclusively of cash**, it is assumed that the net proceeds are equal to the present value of the future payments to be received.

- When proceeds are below the face value, the difference is a discount, increasing the effective interest rate to the market rate.
- When proceeds are above the face value, the difference is a premium, reducing the effective interest rate to the market rate.
- The discount or premium is recognized in a valuation account and is amortized over the life of the receivable using the effective interest method.

Loans receivable also may result from a transaction involving some cash and some **goods and services**, or may involve only goods and services. (These are discussed later in this section.)

Loans also may be **purchased**. In many cases, the amount paid for a purchased loan will include a premium or will be reduced for a discount such that the effective interest rate is equal to the market rate.

Accounting Options

Loans and trade A/R are financial assets and an entity may elect the **fair value option**, as previously discussed. They also may be reported at the **lower of amortized cost basis or fair value**. When neither of these options is elected, however, the loan will be reported applying the **amortized cost basis**.

Initial Measurement

A note receivable is originally measured as the principal balance of the loan, reduced by an allowance for credit losses, adjusted for any discount or premium. Loan origination fees and costs are deferred and included in the carrying value of the loan on the balance sheet.

Interest Income

In each subsequent period, interest is calculated on the carrying value of the loan using the *effective interest rate*. The difference between that calculation and the amount paid, which is calculated on the face value using the *stated interest rate*, is the discount or premium. Reductions due to pricing may be **sales discounts**, in which case, they are accounted for as a **reduction to the sales price and a contract liability**.

- Amortization of a discount increases interest expense and results in an increase in the carrying value of the loan.
- Amortization of a premium reduces interest expense and results in a decrease to the carrying value.
- Amortization of loan origination fees and costs is also reported as an adjustment to interest income.

Loans also may be purchased in which the debtor's credit is deteriorated (**PCD assets**). The purchase price will be discounted to take into account the likelihood that some or all payments may not be collected due to the deteriorated credit. This discount, which is accounted for as an allowance for credit losses, does not affect the amount of interest income to be reported. Only the amortization of the portion of discount or premium that is not related to credit losses is included in the calculation of interest.

In order to recognize income on loans that are purchased with credit deterioration, the entity would need to have a reasonable expectation as to the amount that is expected to be collected. If that is not the case, the loan may be placed on nonaccrual status, indicating that interest income is not accrued. The entity may use the cost recovery method or the cash basis for income recognition. Although interest may not be recognized, the discount due to credit deterioration will be recognized as a credit loss. Under the cost recovery method or the cash basis, the carrying value of the financial asset may exceed the payoff amount. When that is going to occur, interest income may not be recognized to the extent that the net investment will exceed the payoff amount.

Balance Sheet Presentation

Loans and trade receivables are often presented in the aggregate on the balance sheet. That would not include, however, receivables that are *held for sale* rather than for the purpose of receiving the cash flows. Receivables held for sale are required to be reported in a separate line item on the balance sheet.

Troubled Debt Restructuring

Unless the creditor has elected the fair value option, when a debtor is unable to make payments on a receivable as they come due, the debt may be restructured to assist the debtor in making payments. This usually provides the creditor with the greatest amount achievable under the circumstances.

Exclusions

Certain modifications to a receivable are **not** considered **troubled debt restructurings (TDRs)**, including:

- Lease modifications
- Changes to employment agreements
- A debtor's failure to make payments or a delay in taking legal action by the creditor unless there is an agreement to restructure the debt between the debtor and creditor

In addition, the standards exclude the following debt restructurings from the TDR category:

- A transfer of cash, other assets, or equity to the creditor when the fair value of the consideration equals or exceeds the creditor's amortized cost basis
- A transfer of cash, other assets, or equity to the creditor when the fair value of the consideration equals or exceeds the debtor's carrying value of the obligation
- The creditor reduces the effective interest rate to reflect changes to the market rate to discourage the debtor from obtaining funds from another source at the lower market interest rate
- The debtor replaces the debt with new marketable debt with an effective interest rate at or near the market rate for instruments with maturities and interest rates similar to debt issued by debtors that are not troubled

Assets Received in Full Satisfaction

A TDR may provide the creditor with assets or an equity interest in the debtor in *full satisfaction of the receivable*.

- The assets or equity interest received are measured at their **fair values** (less costs to sell if the creditor intends to sell the assets).
- The total recognized for cash, other assets, and equity interests received reduces the amortized cost basis of the receivable.
- The **remaining amortized cost basis** of the loan is eliminated and a **loss on troubled debt restructuring** is recognized for that amount.

If the fair value of the receivable being satisfied is more readily determinable than the assets transferred to the creditor, it may be used instead. Once recognized, the assets received are accounted for as if they had been purchased for cash.

Assets Received in Partial Satisfaction

When the transfer of cash, other assets, and equity is in *partial satisfaction of the receivable*, the terms may be modified in relation to the remaining balance of the receivable. In some cases, the terms are modified without a transfer of assets or equity. Regardless of whether the terms are modified, the remaining collections that are expected to be received on the remaining amortized cost basis under the modified or unmodified terms are measured at their present values.

- The rate used to calculate the present value of future collections is the rate specified in the original contract.
- The market rate at the time of restructure is not used because the loan, as modified, is not considered a new loan but rather an attempt by the creditor to recover its investment.

- The **excess** of the **amortized cost** of the loan **over** the **present value** of the **collections** **expected** to be received is **recognized** as a **loss**.

Writing Off Receivables

Financial assets are required to be written off (partially or in full) in the period in which it is determined that they are **uncollectible**. The asset is reduced to zero and the allowance for credit losses is decreased by the same amount.

Allowance for credit losses	X	
A/R		X

Recoveries of amounts written-off should be credited back to the allowance for credit losses.

Cash	X	
Allowance for credit losses		X

The result is the same as if the account was first reinstated and then credited with the collection:

A/R	X	
Allowance for credit losses		X
Cash	X	
A/R		X

Direct Write-off Method

Under the direct write-off method (used for tax purposes), bad debt expense is recognized when a specific account is determined to be uncollectible. No valuation account is used.

- A/R is reduced when accounts are written off and recorded as bad debt expense:

Bad debt expense	X	
A/R		X

- **Violates GAAP** in two ways:
 - **Not Matching** – Bad debt (ie, credit loss) expense is not recorded at the time of sale.
 - **Not Conservative** – A/R is carried at its face amount, which will overstate the A/R balance in the balance sheet.